Guide to Creating a Sale of Business Agreement for a Small Privately Owned Company

An Honors Thesis (HONR 499)

by

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Abstract

The valuation and sale process for small privately owned companies can be a challenging and tedious task for even the most experienced individuals. Due to the size, variability, lack of public statements and stock value, as well as a number of other differences, such companies can be more difficult to value than publicly traded companies. Although each small business may choose to handle this intricate procedure differently to fit their own unique business models and personal needs, I have created a guide to help prospective buyers and sellers through this process. The *Guide to Creating a Sale of Business Agreement for a Small Privately Owned Company* was created by combining research about the process from a financial and contractual perspective, with real world experience working with a small business owner as a hypothetical prospective buyer. I address the important processes and initial calculations any buyer or seller should go through, and provide a notated template for an example Sale of Business Agreement. This guide could potentially save small businesses thousands of dollars by alleviating the cost of hiring professionals to value their business and mediate the entire sales agreement creation.

Acknowledgments

I would like to thank Ms. Beth Williams for taking on the task of advising me through this project. Her help, along with the education and mentoring I received from my many professors at Ball State University prepared me for this exciting challenge.

I would also like to thank the business owner and manager who gave me the opportunity to apply my research, and my family for making my education and this project possible with your unending guidance and support.

I dedicate this project in the memory of Dr. James Ruebel, Dean of the Honors College for most of my time at Ball State. Thank you for inspiring me to choose Ball State for my undergraduate education and for being a wonderful mentor, professor, and guide.

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Process Analysis Statement

I first came to Ball State as a double major in Art and Entrepreneurial Management. My career goal was to create a business that would provide art and music lessons. I now plan to graduate as a double major in Marketing and Business Administration. My goal of being an owner of such a company didn't change when I changed my major; my options for reaching that goal have expanded. I decided to pursue writing this *Guide to Creating a Sale of Business Agreement for a Small Privately Owned Company* after realizing that rather than starting from scratch, I could buy or manage a similar existing business. After considering this, I approached the owner of the music school I taught at with the proposition of working through the process of creating a hypothetical sales agreement. This would allow me to apply my research and provide a real world experience with which to create this guide. Another benefit of working with this specific business is the opportunity to learn more about the management and capital structure of this type of company. The owner agreed and stipulated that I first sign a Confidentiality Agreement.

My advisor, Ms. Beth Williams of the Entrepreneurial Management Department in the Miller College of Business, is a good fit for my project because of her experience with venture financing and work with small business sales at Ernst and Young. She also signed a Confidentiality Agreement with the business owner. Therefore, throughout the rest of my thesis, I will refer to the business owner simply as the "Owner". Additionally, any numbers, calculations, and valuations I do as I work through the hypothetical sale process will not be provided. I will provide only the formulas that I used and descriptions of the processes, research required, and important meetings and discussions held to reach the final product.

To begin this process, I interned with the company for a summer to learn more about the management, planning, and administration beyond my knowledge as a music instructor. I learned about their bookkeeping processes, scheduling, event and class planning, equipment, and general management style. After the internship was over and the fall semester of my senior year began, I started planning my thesis project and discussed the project with the Owner to receive approval to continue. Shortly thereafter, I met with the Owner and discussed what they would hope to achieve if selling the business. We discussed the current state of the business, their management philosophy and style, vital staff members, and estimated hypothesized potential values. I was also provided with financial statements for the past three years and the current year to date after reading and signing a Mutual Non-Disclosure Agreement. The next step was to analyze the financial statements, calculate financial ratios, and use a variety of valuation methods to determine an appropriate range of values for the business.

Throughout this time period and the beginning stages of my project, I researched the steps associated with selling a business, various Sale of Business Contracts and Agreement Documents, as well as several valuation methods for small privately owned companies. One of the best resources in the early stages of my research was the U.S. Small Business Administration's website, sba.gov. This website contains helpful articles and lists related to the process of purchasing an existing business. It was a great starting point which directed me toward material I would need for further research. The Small Business Administration provided several steps and considerations in the sales process such as "researching the business you want to buy", "determining the value of a business", and evaluating "financial statements…contracts and leases" and "important documents" (Buying an Existing Business). As I continued to research the business, I visited the company's webpage, social media, and the Indiana Small

Business Development Center's (ISBDC) page for the business. I researched financial ratios in my Corporate Finance textbook, found several sources for ways of valuing businesses, and read several templates for Sale of Business Contracts.

I decided to start my valuation process by calculating and analyzing some key financial ratios for the business. I used Besley and Brigham's CFIN5 Corporate Finance Textbook as my main source for ratio formulas and to help me determine which ratios would be most worthwhile investigating (Besley & Brigham). After calculating several ratios for liquidity, asset management, debt management, and profitability, I quickly realized that many of the ratios meant little to me since there were no industry averages for comparison. Since this was a private company in an unusual and small industry, there was no feasible way for me to find comparable averages. However, there were a few ratios that were still helpful in making realizations about the company's financial standing. In order to gain meaning without the guidance of industry averages, I compared the ratios throughout out multiple years to identify trends. The ratios I found most insightful included some of the liquidity ratios (current ratio and quick ratio) and the debt ratio. The two liquidity ratios provide information about the company's ability to pay off current debt quickly if necessary, while the debt ratio demonstrates what portion of the business's assets are financed by debt. I included more information about how to interpret these values based on information found in the textbook by Besley and Brigham in the guide. The CFIN5 book provided the ratio formulas as well; however, these are standard formulas.

Next, I compiled all of the balance sheet and profit and loss statement information into excel files. I could then evaluate and compare the numbers across years and apply vertical analysis. This organization allowed me to recognize the changes and relationships in different values over time. This was a helpful way for me to understand the operations over the span of a few years rather than trying to look at each year separately. Since this was a useful process to evaluate the numbers and understand the company's finances, I decided to suggest in the introduction of my guide for any prospective buyer to create such a spreadsheet and analyze the numbers in this way. When inspecting each financial statement individually it can be easy to overlook large changes or discrepancies that are apparent when comparing line items side by side for each year.

The main issues facing me at this point were to determine appropriate valuation methods specifically for small, privately owned, unique businesses and to find proper ways to format a Sale of Business Agreement or Contract. I decided to first delve into researching various business valuation methods. This led me to several websites and articles from sources such as the U.S. Small Business Administration, Bloomberg, Entrepreneur, Investopedia and more. I also consulted my finance textbook. I began to calculate a variety of valuations for the business to determine possible selling prices. I decided to make multiple valuations using different techniques since many of the methods I found considered different aspects of the business. My goal was to create a range of potential values from the methods with closer estimates and to eliminate valuation methods that created obvious outliers. This way I could compile a list of formulas for the more accurate and reliable valuation methods to include in my guide.

The valuation methods I calculated for the business were the multiple of earnings method, gross income multipliers method, capitalization of earnings method, and present value of estimated future cash flows method. The multiple of earnings method combines different aspects of value to the owner (such as owner's compensation and the company's net income) and multiplies the one year sum of these numbers by a multiplier or capitalization rate to estimate the present value that these profits would have to an owner over a period of time. The gross income multipliers method is similar, but looks at a shorter term. This method focuses on the gross monthly income of the business for one month, and multiplies that by a common industry multiplier or a multiplier agreed upon by the buyer and seller to represent a time period in which the buyer would like to see a return on their investment. The capitalization of earnings method uses the company's earnings before interest and taxes and divides this by a capitalization rate. This method assumes that there will be similar cash flows of EBIT in the future and uses the capitalization rate to put these future cash flows into reasonable present value terms. Lastly, the present value of future cash flows method looks at a cash flow that will be important to the buyer to make a return on their investment, such as average owner's compensation, and divides this by a capitalization rate in order to put this number into present value terms. It is also in this section where I discuss the choice to use a common industry capitalization rate, or to calculate the more accurate weighted average cost of capital to use as the present value factor for the company.

For this particular business, I found that the gross income multipliers method and the capitalization of earnings method provided similar values in a lower range, while the present value of cash flows and multiple of earnings methods provided similar values in a higher range. While this held true in my case due to the formulas' emphasis on different parts of the business, the opposite may be true for a business that is financed differently. The main pros and cons for each of these methods are going to vary based on the company, buyer, and seller needs. This is because each method focuses on similar, but potentially different financial aspects of the business. For example, if the buyer and seller are more concerned about the earnings of the business rather than the owner's compensation as a sign of the businesses financial health as a worthwhile investment, then they would find more meaning in the capitalization of earnings method then the present value of future owner's compensation cash flows. If they are interested in the added value of both, they would likely find the most meaning in the multiple of earnings method. Throughout this process I also found some methods, or versions of methods, that provided huge outliers. Since I used multiple methods I was able to change and choose the formulas to better fit the financing needs of this particular business by comparing the results from the multiple methods. Therefore, I have included these four formulas that did not create unreasonable outliers in my guide. I also included suggestions for variations of the formulas to help fit different business models or buyer and seller needs. Had I only tried one valuation technique, it is unlikely that I could have come to a fair range of offering prices for the business. Although the methods I used still created a rather wide range, these different valuation methods have different pros and cons due to their emphasis on different parts of the business's finances. Those that provide higher valuations are more useful to the seller while the lower valuations are more useful to the buyer during negotiations. These values could then be averaged or negotiated until the buyer and seller can agree on a final value.

To convert this research into something usable for the average buyer and seller beginning this process, I summarized my findings. I did this by providing and explaining the formulas, and providing an explanation of why it is important to consider many valuation options. Due to the variation in values and the potential for a wide range of prices that can be gathered using these methods, I also suggest the importance of having a professional appraise the value of the business as well. Finally, I also talked about the importance of not only looking at the tangible numbers in the valuation process, but also the value that the buyer could add to the business, the seller's needs and considerations, and the buyer's ability to finance the purchase of the business.

Due to the intangible value of other aspects of a business, such as intellectual property, it is possible that the final offering prices may reflect more than only the financial situation of the business in question. However, it is important to fully analyze the finances and valuation of the business so that the buyer and seller do not get into a financial situation that is likely to lead to bankruptcy for either party.

Learning about valuation methods while working with an actual business helped me realize those aspects beyond the financial facts. Elements beyond the numbers for consideration are; the seller's priority for job security for key staff members, the need for the buyer to maintain the current management style, and the proper handling of the seller's intellectual property. Other considerations include the value that I as a potential buyer could bring to the table, such as in-depth knowledge of the business, respect for the seller's wishes in the continuation of the business, and flexibility in the seller's continued role in the business. These are all considerations that I will be including in the guide. The last consideration was the buyer and seller's current financial positions and the ability and options available to finance the sale. I will pursue in greater depth the implications of financing options in the Reasons to Buy and Red Flags section of the guide. After researching several options and considering my own financial standing in relation to the business I was working with, it seems that the most secure option is owner financing. This is the option I discussed in most detail in the guide.

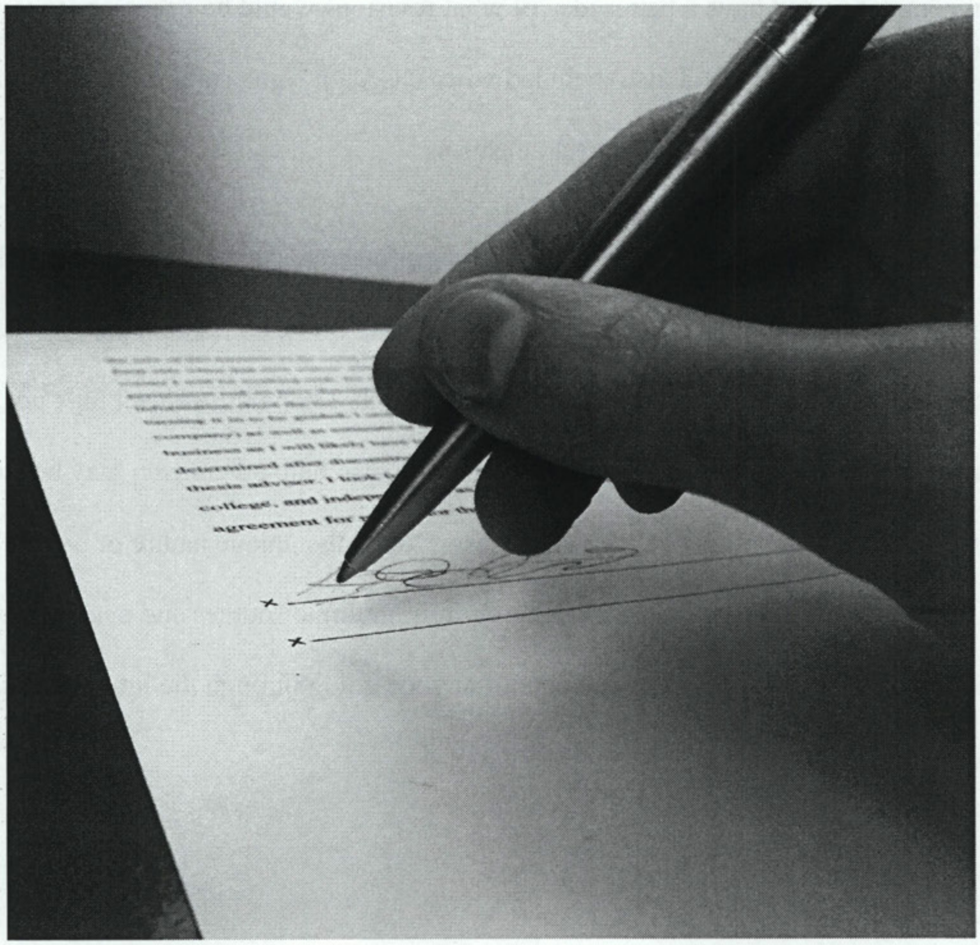
The final section of my guide is the Notated Sale Agreement Template. In addition to applying contract knowledge from my Business Law class and looking back over contracts I have signed in the past, I researched several resources about writing a contract in order to write the example contract document. The resources included guidelines to contract writing, specifically sale of business agreements, as well as example sale of business agreement templates. I used these sources to make certain I understood the necessities, and to become more familiar with the language of contract writing. Most of the templates I found were simplified, so I compiled the information from all of the sources to create a more comprehensive template. The notation portion of the template exists to add clarity to the different sections so anyone writing their own contract would have a better idea of what revisions would be necessary to tailor this contract to their specific needs. I also included notes based on conversations and considerations from my experience working with an actual business.

Overall, this process helped me to not only reinforce concepts I learned in my finance, accounting, management, and business law courses at Ball State, but to gain additional insight and experience from secondary and observational research. I hope this project may not only benefit me as I pursue a career as a business owner, but also help others who may be struggling through the process of buying or selling a business. Due to the unique nature of privately owned companies, I believe this compilation of research from multiple sources and personal experience into one comprehensive document could benefit anyone going through the intricate process of the purchase or sale of a privately owned company.

Guide to Creating a Sale of Business Agreement

for a

Small Privately Owned Company



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Introduction

The valuation and sale process for small privately owned companies can be a challenging and tedious task for even the most experienced individuals. Due to the size, variability, lack of public statements and stock value, as well as a number of other differences, such companies can be much more difficult to value than publicly traded companies. Each small business may choose to handle this intricate procedure differently to fit their own unique business models and personal needs. I have created a guide to help prospective buyers and sellers through this process. Hiring a consultant to mediate the process can cost companies and individuals thousands in fees, but trying to go through the process unaided can be confusing, challenging, and conflict ridden. Although this guide cannot take the place of legal counsel, I hope it can save time and money by going step by step through the basic processes required to calculate a fair offer and create contract terms that will be mutually beneficial for both buyer and seller.

Throughout this guide, I will be discussing and explaining different reasons to buy, important financial ratio calculations and analysis, different valuation methods specific to small privately owned companies, and red flags for buyers and sellers. I have also provided an annotated template of what to include in the final Sale of Business Agreement Contract. In order to create this guide, I have compiled research from many sources such as the Small Business Administration and college business textbooks. I then applied that research to a real business, working with the Owner to find which financial ratios, valuation methods, and management considerations are most important and reliable when looking specifically at unique small businesses that cannot be compared to industry averages or similar publicly traded competitors. I will be citing my sources throughout this document so that any reader may consult my Works Cited and Consulted to learn more from the source documents.

Before you begin the process of buying or selling a business, please keep in mind these few important considerations. Working with small companies can be an extremely delicate due to the personal nature of the decision processes of privately owned companies. I also suggest the buyer and seller sign a Confidentiality Agreement (or Mutual Non-Disclosure Agreement) before discussing or providing any financial information. This agreement ensures that no party may use or share information provided by the other in ways that have not been authorized. This contract can provide value to both the buyer and seller. For the seller, it ensures that private company information such as any financial statements and information provided to the buyer cannot be disclosed to third parties. It can also show that the buyer is serious about the negotiations if they are willing to sign this document. For the buyer, this agreement can help your ethos with the seller. The document will also be necessary if you wish to be granted access to important company information and documents that will be necessary during negotiations and price evaluations.

Once the evaluation and negotiation process begins, it is advisable to keep lines of communication open for questions that will arise as analysis of financial statements and business processes progress. Small private business sales will include much more personal contact and less standardized processes than a large business to business transaction. Therefore, my main advice before continuing in this guide and this process is to be reasonable, open to negotiation and discussion, and sensitive to the needs and abilities of both the buyer and seller.

Reasons to Buy and Red Flags

There are several good reasons to invest in an existing business. Perhaps you are looking at alternatives to creating your own business. Perhaps you are looking to be in a higher position in a company you already work for, or you are being trained as a business's successor. Maybe you would rather own a certain established business in a specific industry and location rather than try to compete. Or perhaps you love a certain business and would like to buy it rather than see it fail or change. Buying an existing business is also a great way to become highly involved in a certain industry faster than one normally could by starting and building their own business. Regardless of the reasons a buyer may have, it is important for the buyer to consider potential Red Flags pointing to the sale's eminent failure before taking on such an important investment. The same can be true for the seller. If the seller has certain expectations in mind for the continued operations of the business, it is important that the seller find a proper and fitting buyer. In this section, I will briefly discuss some things to look out for and consider before getting too involved in serious negotiations.

Red Flags for Buyer

1. Know why the business is being sold.

    A business owner may be selling a business so they can retire and ensure the business's continued success, or they may be selling because they want to get out of the business before it goes under. Other reasons a business is being sold could include; estate planning, desire to pursue new ventures, management dissension, and more. Make sure the seller's reasons for selling are fair to the buyer, or that you have a plan to reinvigorate a struggling business before committing to a sale.

2. Question poor financial performances

Before making an offer, be sure to understand the financial situation of the business. Financial ratios can provide a quick way to gauge the financial health of an organization. While they may not always tell the whole story, they can be a good place to start and shouldn't be ignored. We will discuss financial ratios further in the next section.

3. Vague answers

This again relates back to knowing why the business is sold and understanding the business's current financial standing. Communication is key in any negotiation process, so be certain to seek clear answers to any questions that may arise.

4. Won't allow full financial evaluation and inspections

If a business owner does not provide financial information, the seller will be unable to make an informed decision. It will be impossible to determine a fair offering price without access to financial statements for accurate and honest information.

5. Lack of communication

Be certain to schedule meetings with enough time to communicate all questions. It may also be advisable to have multiple means of communication and several contacts within the company to ensure you are able to fully understand the business before making any final decisions. Without open lines of communication it can be difficult for buyer and seller to reach any mutually beneficial conclusions.

6. Methods available to finance purchase

If the buyer is not able to pay the full amount up front out of pocket, there are a few options for financing. One option may be to seek out grants from the city, as it is likely in their best interest for the business to continue to succeed. Another option is to take out a loan from a bank or other financial institution to pay the owner in full and then make regular interest and principle payments to the financial institution. The most secure option for the buyer may be to create a contract under which the seller finances the purchase and receives a down payment, followed by regular principle and interest payments from the buyer for a set amount of time. This option is called "Owner Financing" (Wright).

Owner financing is similar to buying a home on contract from an owner. Owner financing is beneficial to the buyer because it can prove that the seller is confident that the business and the buyer will have continued success. It is also a way to lower buyer liability by using the business as the main collateral for the loan. This can also be beneficial to the seller because it ensures that if the buyer ceases payments or breaks the contract, the business will go back to the seller rather than to a bank or financial institution.

7. Management Issues

A small business may have a smaller number of more closely connected managers and employees. Because of this, there is a greater potential for problems and conflict to arise in management due to a lack of standard management procedures and protocol. This can be amplified by the existence of strong company culture established by a previous owner or founders of the business. There may also be a need for restructuring. *Contemporary Management* defines restructuring as "downsizing an organization by eliminating the jobs of large numbers of top, middle, and first-line managers and non-managerial employees" with the specific goal of reducing costs (George, Jones, & Jones). If it will be necessary to restructure management as a new owner and manager, this will likely be another cause of conflict. It is important to do all you can to ensure the continued success of the company while still considering the current employees. This becomes especially important if the business you are looking to buy relies on services rather than tangible goods in order to create revenues. Be ready to handle turbulence as employees and fellow managers adjust to the changes created by transferal of ownership and do what you can to ensure a smooth transition for all employees.

8. Pending Legal Matters

Make sure that you are aware of any pending legal matters that will need to be attended to with the business in question. This could include lawsuits against the business, lawsuits the business has filed against any other party, and potential licenses you will need to obtain in order to legally own and operate the business. If possible, you should negotiate for any outstanding litigation to stay with the seller.

9. Other Stakeholders

There may be other parties important to the sale besides the buyer and seller. This could include any other investors, important business partnerships, key employees, and leaseholders. If the business is owned by multiple people or the building is being leased you will need to make certain you understand who you are buying from and what you are purchasing. You will need to know exactly what is included in the sale; for example, if the owner leases or rents buildings or equipment, it is the lease that will be transferred in the sale, not the building itself. Therefore you will be working with the current building's landlord as another potential stakeholder.

10. Existing Contractual Arrangements

If the company currently contracts outside employees, these contracts may not be able to be transferred in the case of new ownership. Have a plan in place to replace, continue, re-write or handle any legal action that may be necessary regarding these contracts whether you wish to continue, terminate, or renew these agreements. Aside from employee contracts, there may also be leases, lending agreements, equipment rentals, and other contracts to consider.

Red Flags for Seller

1. Uncooperative or Pushy Buyer

If the buyer is coercive or unwilling to discuss the seller's needs, they may not be the right person for your business. A buyer who is unbending on terms or value is not only more likely to undervalue the business, but is less likely to continue in the seller's current management style. If it is important to the seller that the company culture be maintained after the sale, then the seller may want to reconsider negotiating with an uncooperative or pushy buyer.

2. Not willing to sign Confidentiality Agreement

If the prospective buyer is not willing to sign a confidentiality agreement, the seller will have no protection if the buyer discloses private business information to any third party. Unwillingness to sign a non-disclosure agreement can also be a sign that a buyer is not serious about the proposition of buying the business or that they may have ulterior motives for acquiring the business's financial information. Therefore, no conversation should proceed without first signing a mutual non-disclosure or confidentiality agreement.

3. Buyer won't disclose any of their financial situation

If a buyer is unwilling to disclose any financial information, it is possible that they may not have the means to finance the purchase of the business. If a business owner chooses to sell on contract (owner financing) rather than receiving a lump sum from the buyer, it would be wise to understand the buyer's ability to repay the loan beyond the income they will receive as owner. In this case, the seller has the right to do as thorough of a credit check on the buyer as any financial institution would before approving a loan. The seller should also ensure that the buyer is capable of making a reasonable down payment.

4. Lack of communication

For the same reasons as those provided in the Red Flags for Buyer section, it is important to maintain honest and open communication for the mutual benefit of both buyer and seller.

5. Buyer's prior experience

Any seller concerned with the continuation of their business by a successor should look at the process similar to hiring an employee. Choosing a buyer is an important decision to ensure the business has a successful future. The buyer's experience and ability to run the business is as important as their ability to finance the purchase. Requesting a resume and providing training would be a good idea for any seller who wants to stipulate that the business continue to be run in a manner that conforms to its original mission, goals, and organizational culture.

Financial Evaluations

It is important to understand the financial standing of the business in question before making or accepting any offer in a sale of business transaction. A great starting point is financial statement evaluation. I would suggest gathering financial statements for the past three to five years. At the minimum, this should include balance sheets and profit/loss (income) statements. If possible, it may also be useful to look into the company's statements of cash flows, retained earnings, and any other financial information they are willing to disclose. The financial ratios I will discuss in this section can generally be calculated using values from the balance sheet or income statements.

Before calculating any financial ratios, you should begin by familiarizing yourself with the financial statements, comparing the numbers year to year, looking for and asking the business owner or accountants any obvious questions you may have, and making certain you understand where the numbers are coming from for the specific company. A good way to evaluate the changes in statements is to compile them into a single spreadsheet where you can see the line items for each year side by side. You can then compare the amounts in each line, as well as creating percentages "of a base figure within the statement" to evaluate percent changes and weights for each value to gain a better understanding of the business's financial structure. (Vertical Analysis of Financial Statements). This method is called vertical analysis, and will make any large changes in values or new line items easy to find and may provide you with some initial questions to ask before continuing your financial analysis.

Another important consideration for the buyer is the accounting method. It is important to ensure that the financial statements you are analyzing for the business have been either created by or examined and thoroughly audited by a third party external accountant to ensure their accuracy and trustworthiness. If the company uses an external accountant, this should already be taken care of. However, if the company uses an internal accountant then further inspection should be made. You will also want to examine tax returns to gather further information and perform due diligence of the financial analysis process. This will also include examining deeds to any owned property, examining leases to any rented property, and understanding any outstanding contracts. All of this is to ensure that the buyer and seller both understand the assets acquired and liabilities assumed in the sale and to verify the reliability of the numbers provided by the selling company. Similar to a bank doing a credit check before providing a loan, it is imperative to fully understand the value of what is being sold before making any kind of large business purchase or sale.

Financial ratios can serve as Key Performance Indicators when objectively analyzing a business. A Key Performance Indicator is any measure that "helps you understand how your organization or department is performing" and can include ratios or other financial, customer, and process metrics (Jackson). Financial ratios can tell you a great deal about the financial health of an organization. However, I do not suggest making any final decisions based on financial ratios alone when dealing with small privately owned companies. Differences in project financing and capital budgeting methods without the use of common stock can sometimes translate into inaccurate financial ratios. Since we are assuming that there are not industry or competitor averages for comparison, I will provide you with general assumptions about each of the following ratios. However, competitor ratios can be a reference point for comparing and understanding the ratio values if they exist for your company. Remember though, that what may be considered a poor ratio for the average company may not necessarily provide an accurate reflection for the specific privately owned company you are analyzing.

The following is a list of key financial ratios and what kind of results to look for. These are all ratios that you may find helpful when looking at a company's Liquidity, Asset Management, Debt Management, and Profitability. The ratios that I find most helpful and consistent to quickly assess the financial health of an organization in each of these areas are the Quick Ratio, Total Assets Turnover Ratio, Debt Ratio, and Net Profit Margin. When looking at manufacturing or sale of inventory-based organizations rather than service-based organizations, the Inventory Turnover Ratio will be an important factor as well. While these ratios will not provide you with the value of the business, they can help you determine the risks of the business and therefore help you decide if you want to invest. They can also make it easier to evaluate ways that a buyer may want or need to reorganize the business's finances to increase profitability and liquidity and improve future budgeting.

Financial Ratios

Measure	Ratio	Formula	What to look for
Liquidity	Current	<u>Current Assets</u> Current Liabilities	The higher this ratio the more liquid the company is. This means that the assets can be more quickly converted into cash. A company with greater Liquidity is better "able to meet its current obligations" (Besley 30). Ideally you want this number to be greater than one.
	Quick (Acid-Test)	<u>Current Assets- Inventory</u> Current Liabilities	This ratio is very similar to the Current ratio, except that it excludes Inventory. This ratio is more useful for a company whose inventory will not be sold quickly and cannot be quickly converted into cash assets.
Managing Assets	Inventory Turnover	<u>Cost of goods sold</u> Inventory	This ratio tells the average number of times "each item of …inventory is sold and restocked, or turned over" in a year (Besley 32). If this number is low it can imply that the company may be holding too much inventory or holding inventory for too long or holding obsolete inventory.
	Days Sales Outstanding (Accounts Receivables Turnover)	<u>Accounts Receivables</u> Annual Sales/360	The Accounts Receivables Turnover measures "the average number of days receivables remain outstanding before they are collected (Bragg)." This ratio can be useful for companies that have large amounts of current assets tied up in accounts receivables. Note* This ratio is not relevant to business that deal only in cash.
	Total Assets Turnover	<u>Sales</u> Total Assets	This number may be more helpful to gauge asset management for companies who don't rely as much on selling inventory. If this number is low it can mean that "the company is not generating a

			sufficient volume of business given its total investment in assets" (Besley 32).
Managing Debt	Debt Ratio	Total Liabilities / Total Assets	This ratio gives you "the percentage of the firm's assets that are financed by borrowing (loans)" (Besley 34). In general you would want this number to be low to show that the owner has a higher equity and ownership in the business, but there are also several reasons a company may choose to finance their ventures using debt, so be sure to question why if this ratio seems exceptionally high. Ideally this number should be less than one.
	Times Interest Earned	Net Operating Income / Interest	Times Interest Earned "measures the extent to which a firm's operating earnings…can decline before these earnings" are not able to pay "annual interest costs" (Besley 34). A higher Times Interest Earned number is better.
Profitabilit y	Net Profit Margin	Net Income / Sales	Measures the firm's profitability as a percent of sales. Greater profit margin percent means greater profit per sale. Negative profit margin means the company is losing money.
	Return on Assets	Net Income / Total Assets	This number is a percentage of the income being made in relation to the company's assets. You want a positive percentage for return on assets.
	Return on Equity	Net Income / Common Equity	This measures the income percent return on the owner's equity. However, this number may not mean as much in a small company who pays its owner a separate salary as an expense outside of equity or dividends.

Valuation Methods for Small Private Businesses

Determining an acceptable, fair offering price for small privately owned companies can be a confusing process. For finalizing this process I suggest having a professional financial advisor or accountant appraise the business, but this section should help get you started and determine a reasonable range of estimations. Calculating some of these formulas yourself by hand can help both the buyer and seller gain a better understanding of the financial situation as it forces you to look closely and carefully at the numbers. It can also help both the buyer and seller know whether they can realistically consider making or accepting an offer based on their own financial standing before taking the time and money necessary to hire a financial appraiser. Be aware that the different methods presented in this guide will likely have widely varying results, which will provide you with a range of possible values. For this reason it is important to consider using several different valuation methods rather than relying solely on one.

Each of the different valuation methods will put emphasis on different areas of the company's financial health. Therefore, different methods may be more suited to different types of businesses. In this guide we will look at four specific formulas to compare, followed by other methods and considerations when calculating a business valuation. The formulas we will be discussing in further detail are the Present Value of Future Cash Flows Method, the Capitalization of Earnings Method, Gross Income Multipliers, and the Multiple of Earnings Method. For each of these methods, you will be provided with an explanation, an example formula to use to calculate the valuation, and potential variations on the formula depending on your business and the needs of the buyer and seller. The following Income Statement will be used for the example valuations.

Income Statement

Example Company

Financial Statements in U.S. Dollars

Revenue			
Gross Sales		999999	
Less: Returns and Allowances		11111	
Net Sales			988888
Cost of Goods Sold			
Beginning Inventory		77777	
Add:	Purchases	444444	
	Storage Expense	5555	
	Direct Labor	222222	
	Indirect Expenses	1111	
Inventory Available		751109	
Less: Ending Inventory		55555	
Cost of Goods Sold			695554
Gross Profit (Loss)			293334
Expenses			
Marketing		1111	
Amortization		222	
Bank Charges		444	
Depreciation		3333	
Employee Benefit Programs		22222	
Insurance		8888	
Interest		1111	
Licenses and Fees		444	
Miscellaneous		333	
Office Expense		222	
Rent		22222	
Repairs and Maintenance		1111	
Supplies		777	
Telephone		2222	
Travel		333	
Utilities		7777	
Owners Comp		88888	
Total Expenses			161660
Net Operating Income			131674
Other Income			
Gain (Loss) on Sale of Assets		(2222)	
Total Other Income			(13333)
Income Taxes		(11111)	
Net Income (Loss)			118341

Present Value of Future Cash Flows or Discounted Cash-Flow Method

This method takes some estimation of a future annual cash flow and divides it by the capitalization rate for the company to compute the present value of those future cash flows. This method essentially treats the cash flows of the business as a perpetuity and calculates the "present value" of these "perpetual annuities" (Besley 71). Depending on the business or what the buyer seeks to gain from purchasing the business, this cash flow could be estimated owner compensation, net income, gross profit, a combination of owner's compensation and net income, or another type of future cash flow projected for the business as a representation of its value to the buyer. That value would then be divided by a present value factor, which in our case would be the business's capitalization rate.

The most accurate capitalization rate would be to calculate the Weighted Average Cost of Capital for the company, which takes into account the weighted costs for the company's debt and equity. Another feasible capitalization rate would be the Internal Rate of Return. For a small private company, these capitalization rates may be difficult to accurately calculate due to the private nature of their equity financing, in which case you could use an industry average capitalization rate. When in doubt about what to use as a capitalization rate, you can use the current one-year Treasury Bill Rate to help you "put an upper limit on your valuation" (Robbins). The logic behind using the Treasury Bill Rate is that you could make the same investment in Treasury Bills for less effort to make this amount of return.

<u>Example</u> (assuming a 20% capitalization rate as the present value factor):

3 Year Average Owner's Compensation / 0.2 = Present Value of Future Owner's Compensation

For example, if the Income Statement provided, the owner's compensation was $88,888. If we assume that that has stayed the same, then the average owner's compensation would still be $88,888. Therefore, we divide that number by a 20% capitalization rate:

$88,888/ 0.2= $444,440

Our valuation for the company based on the present value of future owner's compensation would be $444,440.

Capitalization of Earnings Method

The Capitalization of Earnings Method is very similar to the Present Value of Future Cash flows Method; however, rather than just using a fitting cash flow, the Capitalization of Earnings Method uses the EBIT. The EBIT of a company is their Earnings Before Interest and Taxes and can be found by adding interest and taxes back into the Net Income. Again for the following example we will assume a 20% capitalization rate.

<u>Example:</u>

EBIT / 0.2 = Value of Business

In Example Company's Year 1 income statement, the net income was $118,341. The income taxes were $11,111 and the Interest expense was $1,111. Therefore, we would add back taxes and interest to the net income, and divide by the capitalization rate for the company. If we continue to assume that the capitalization rate is 20%, then the valuation would be as follows:

$$EBIT= \$118,341+ \$11,111 + \$1,111 = \$130,563$$

$$EBIT/20\%= \$130,563/ 0.2 = \$652,815$$

As you can see by comparing this method with the previous method, the valuations are very different based on this Income Statement. In this case, Example Company has a relatively low owner's compensation and a relatively high EBIT. When using the same capitalization rate, this causes the values to be drastically different. This is an example of why it is beneficial to think of where the buyer would like to make a return on their investment, what the seller hopes to get out of the sale, and what kind of business you are looking at. For a business owned by a single proprietor and being bought by an individual, the owner's compensation might be a more viable option for determining the value to the buyer and seller. For a larger company being bought by another company, the earnings of the company itself may be more relevant than the owner's compensation. These numbers would also be closer if rather than using only the owner's compensation in the present value method, we had used a combination of cash flows. These large variations in valuation techniques are why it is important to consider multiple possible valuation methods rather than relying on only one method for your company.

Gross Income Multipliers Method

This method focuses solely on a company's gross monthly income and a multiplier. The multiplier can be determined by using the industry multiplier, or a multiplier agreed upon by the buyer and seller based on the return the buyer requires of the business. For our example, we will use a common industry multiplier of 4. By using 4 as our multiplier, this example would essentially represent an average income for one third of the annual business cycle. Keep in mind this number may vary based on the industry of your business.

Example:

Gross Monthly Income x 4 = Value of Business

If we assume that the gross income margin of the year shown in Example Company's Income statement was equally distributed throughout 12 months, then we can find the monthly income by dividing their gross income of $293,334 by 12 months:

Gross Monthly Income $293,334 / 12 = $24,444.5

We would then multiply this monthly income by a common multiplier of 4, to represent the return the business would make in 4 months as a potential valuation of the business.

$24,444.5 x 4 months = $97,778

This valuation method brings us below the value in the Present Value of Future Cash Flows of Owner's Compensation model that we first evaluated. This is again due to what the valuation method focuses on. This method looks at the gross income on a month to month basis, rather than seeking to find the present value of an income over a longer term. This valuation method may create an underestimate for a business that is service based and therefore has a higher labor expense in relation to their income. For a business with a relatively high gross income and lower cost of goods sold in relation to their other expenses, this could be a more fair valuation method. This method is often used for commercial real estate valuations.

Multiple of Earnings Method

This method combines the Net Income, Officer Salary or Owner's Compensation, Interest, and Income Taxes of a company and uses a multiplier or capitalization rate to convert these values into present value terms. You can choose to use last year's financial information for your valuation or an average of the past few years' financial information. I will provide two examples for this valuation method. The first will assume a common multiple of earnings for small businesses of 3. The second will assume a capitalization rate of 20%.

<u>Example 1:</u>

(Net Income + Owner's Compensation + Interest Expense + Income Taxes) x 3 = Valuation

Using the numbers from Example Company's Income statement, the equation is as follows:

($118,341 + 88,888 + 1,111 + 11,111) x 3 = 219,451 x 3 = $658,353

<u>Example 2:</u>

(Net Income + Owner's Compensation + Interest Expense + Income Taxes) / 0.2 = Valuation

Example Company:

$219,451 / 0.2 = 1,097,255

The Multiple of Earnings method essentially combines the Present Value of Future Cash Flows and the Capitalization of Earning's methods. This explains why its valuation is inherently higher than the previous methods. This method would be good for a negotiation that would like to consider the company's income and the owner's income as both being beneficial and valuable to the buyer. In both of these examples, the capitalization rate and the multiple of earnings act as present value factors. As I mentioned previously, the most accurate capitalization rate for your business will be the business's WACC or weighted average cost of capital. This is the cost of the business's financing methods and takes into account the cost and amount of the company's debt and equity. When possible, the WACC should be substituted for the capitalization rate. The formula for WACC is as follows:

$$WACC = [\ E / (E + D)\ ] \times (Ce) + [\ D / (E + D)\ ] \times (Cd) \times (1 - T)$$

Where:

E= value of company's equity

D= value of company's debt

Ce= Cost of Equity (rate of return + risk premium)

Cd = Cost of Debt (interest rate)

T= corporate tax rate

Other Valuation Methods

A valuation method that may be more suited to high inventory businesses that own significant plant and equipment, land, and/or buildings would be Asset Appraisal. To apply the Asset Appraisal method, calculate the value of the assets involved in the sale. This method would look less like a present value calculation and more like a sale of goods transaction by valuing the company as the sum of their tangible assets less any outstanding debts. Other similar methods that focus on the assets of the business include the Replacement Cost Method, in which one "considers the total cost of reproducing operations of the business in today's environment" and the Total Invested Capital Method (PrivCo). For service businesses or businesses that do not hold inventory or own their retail space, this would not be a recommended valuation technique.

So far we have looked at formulas to find the present value of the business as well we asset valuation methods. Another method that may be feasible for companies with common business models would be to compare your company to similar companies with known values. These values could come from past private transactions. For this method to work, the compared company should be in a similar location, in the same industry, and of a similar size. For very unique types of small businesses, this method may not be possible. It also may be necessary to have the help of an appraiser to find these comparable values.

Important Considerations

Although the financial health, stability, assets, and compensation that are considered in the previous valuation methods are important and should be thoroughly analyzed, it is important to also consider intangible assets and the company's ability to grow. These intangible assets to consider could include the company's "industry…location, and the local labor pool" as well as "intellectual property" and unique talents and abilities of key staff members (Quittner).

The financial power and leverage of the buyer is also an important consideration. Beyond just the buyer's ability to finance the purchase using owner financing, a financial institution, or their own source of funds; the buyer may have intangible value to the seller as well. For example, if the buyer is willing to offer job security to key staff members or a continued role for the previous owner to maintain their legacy in a particular way. These considerations can complicate the already challenging process of small business valuation even further. It is for these reasons and more that it may be necessary to hire a business appraiser if the buyer and seller are unable to reach an agreeable valuation from the range of values provided by the previous methods.

Writing a Sale Agreement

As a preface to the example Sale Agreement I would like to remind the reader that this is not an official legal document and should therefore be revised or re-written, edited, and reviewed by a lawyer to better fit the needs of any real transaction before use. This exists to be used as an example and template for anyone wishing to write their own sale contract before consulting their lawyer. The following annotated document contains the minimum necessary elements, as well as suggested elements I feel are important in a Sale of Business Agreement Contract specifically for the transferal of ownership of a small privately owned company. Before attempting to complete or negotiate any large transaction such as a sale of business, it is important to consider every factor and be very detail oriented in order to reach a mutually beneficial solution for buyer and seller. I would suggest consulting and understanding the following document before and during negotiations.

Notated Sale Agreement Template

At the start of the document, be sure to include the date when the contract will become valid as well as both parties to the contract.

This Sale of Business Agreement, made on this __________ day of _______, 20____ by and between __________________________________ of ______________________________ Company (hereinafter referred to as "Seller") and ____________________________________ (hereinafter referred to as "Buyer")

WHEREAS the Seller desires to sell and the Buyer desires to buy the business of ____ currently being operated at ____ and all of the associated assets specified in the attached *Schedule "A" form.

**Schedule "A" or name of attached form containing all the assets included in the sale agreement.*

THEREFORE the Seller and Buyer agree and concede as follows:

1. **Price Information**

Part "a" of Section 1 may be more or less inclusive as deemed necessary.

a) The total purchase price for all tangible and intangible assets including leases, furnishings and equipment, goodwill and company information, and the business name is $__________________.

b) Dollars payable in cash, certified or bank checks upon execution of this agreement is $_____________.

c) $______________ additional to be paid at the time of transfer

d) $______________ additional to be paid in equal monthly increments over the period of ________ *(years or months) with an interest rate of *__________% annually OR $____________ additional to be paid in full without interest charges. The buyer may also decide to prepay the remaining amount at any time during the ________ *(years or months) with no penalty.

**Part "d" of section one represents if the buyer and seller agree to an owner financed sale. If this is not the case, then part "c" should contain the whole amount of the sale transaction to be financed by the buyer.*

2. **Seller's Duties**

The Seller will need to compile a Bill of Sale Form to state what is included in the sale, the selling price, and other terms as proof of purchase for the buyer.

a) The property to be sold shall be conveyed in a standard *Bill of Sale form, duly executed by the Seller.

b) The Seller will provide reasonable and valid titles to all property to be purchased by the Buyer. Full possession of said property will be transferred in the same condition it is currently in with minor exceptions for reasonable wear from everyday use.

Part "e" of Section 2 can outline any previously discussed contingencies that act as duties of the Seller required prior to the final sale transaction.

c) The Seller will maintain any existing insurance on the property until the property is officially transferred to the Buyer with a complete Bill of Sale.
d) The Seller will continue to make payments on any outstanding payables until the title is officially transferred to the Buyer, at which point any of the businesses outstanding liabilities will also transfer to the Buyer.
e) *Outline any other important duties and responsibilities of the Seller.

**Part "c" of Section 3 can outline any previously discussed contingencies that act as duties of the Buyer in order to complete the final sale transaction.*

3. Buyer's Duties

a) The Buyer is responsible for paying Seller as indicated in section one of this document.
b) If buyer fails in payments, prior payments shall be held as deposits and retained by the Seller as collateral for damages.
c) *Outline any other important duties and responsibilities of the Buyer.

**Please be aware for Section 4 that Non-Compete Clause Laws vary by state. Consult your state's laws regarding non-compete policies before writing this section of your contract.*

4. Non-Compete Clause *varies by state

a) In this section you will outline a non-compete clause stating that the seller may not compete within a certain geographical radius for a certain number of years. This will protect the value of the sale and ensure that the seller does not use trade secrets to compete locally and reduce the value of the transaction for the seller.

5. The Broker's Fee to cover any and all professional services provided to aid in the creation and legal witness of this document in the amount of $__________ is due from the Seller to the Broker, ______________, on the date __________ of ______________, 20______ under the conditions that the papers pass and this contract is valid.

Sections 6 and 7 outline any contingencies of the sale for both the buyer and seller and should contain any agreed upon actions that the buyer and seller wish to make legally binding for both parties.

6. The Seller agrees on the following contingencies for this Sale of Business Agreement to be binding for the Buyer (the following are examples only and not necessary for a Business Sale transaction.):

a) Buyer will assume the lease of the current business facilities located at…
b) Buyer will obtain approval for transfer of licenses…

c) The property will remain in same condition before the sale is finalized…
d) *Any other contingencies the Buyer Requires of the Seller

7. The Buyer agrees on the following contingencies for this Sale of Business Agreement to be binding for the Seller (the following are examples only and not necessary for a Business Sale transaction.):

a) The Buyer will provide job security for the following employees for the next 12 months: …
b) The Buyer will maintain the current name of the business for the next 50 years or the life of the business…
c) *Any other contingencies the Seller Requires of the Buyer

Sections 7 and 8 deal with the legal actions that can be taken by either party if the contract should be terminated or violated and provide the state that will preside jurisdiction over this agreement.

8. Termination

a) If this agreement is terminated before the date specified in the beginning of this document…
b) If this agreement is terminated after the date specified in beginning of document- property and money transferred thus far as collateral…
c) If Sections 6 and/or 7 are not upheld by either party at any time after the signing of the document…

9. General Provisions

a) This document shall be upheld and governed by the laws of State of ______________
b) The contents of this document represent the mutual understandings and agreements of both Buying and Selling Parties and shall supersede all prior written or oral understandings between the aforementioned parties.
c) No amendment or addition to this document will be binding to either party unless signed and dated by both parties at the time of the amendment.
d) Breech of this contract by either party shall result in…

IN WITNESS WHEREOF, the buying and selling parties have caused this Sale of Business Agreement to be executed on the date and year first written above.

Seller:

Seller's Name: ____

Seller's Company: ____

Seller's Signature: ____

Date: ____

Buyer:

Buyer's Name: ____

Buyer's Company: ____

Buyer's Signature: ____

Date: ____

Broker:

Broker's Name: ____

Broker's Company or Firm: ______________________________________

Broker's Signature: ____

Date: ____

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